OFGEM DECISION LETTER No. 0559
"Changes to Buy Back Liabilities"
Version 1.0

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Transco, Shippers and Other Interested Parties

Dear Colleague,

Modification Proposal 0559 'Changes to Buy Back Liabilities'

Ofgem has carefully considered the issues raised in Modification Proposal 0559 *'Changes to Buy Back Liabilities'*. Ofgem has decided to accept the proposal because we believe that this proposal will better facilitate the relevant objectives of Transco's Network Code.

In this letter, we explain the background to the modification proposal and give the reasons for making our decision.

Background to the proposal

Transco has allocated monthly entry capacity rights to access the National Transmission System (NTS) via six monthly system entry capacity ('MSEC') auctions since September 1999. The next auctions of MSEC are due to commence on 16 August 2002 and will offer capacity for the six-month period commencing 1 October 2002. Transco also offers entry capacity on a day-ahead and within day basis, to the extent that it can physically make available such capacity. Transco also releases a use-it-or-lose-it interruptible capacity product at the day-ahead stage. This product is intended to prevent the hoarding of firm entry capacity by shippers.

In the event of a constraint at an entry point, when physical capacity available is less than the capacity sold against which gas is flowing, Transco may curtail interruptible capacity rights. To the extent that a capacity shortfall remains after curtailing interruptible capacity, Transco buys back firm entry capacity rights at market prices until the constraint is relieved.

Transco has financial incentives to efficiently manage the costs of buy-backs. Following Ofgem's acceptance of Modification Proposal 0540, '*Delay of Licence and Effects on Capacity Incentives'* on 28 March 2002, new parameters were introduced to Transco's buy-back incentive with effect from 1 April 2002 to 31 March 2003. Transco faces a £35 million target level of net buy-back costs and is rewarded for performance below target and penalised for performance above target. Transco's possible revenues and costs under this incentive are subject to a cap of £30 million and a collar of £12.5 million.

The net payments and costs arising from Transco's performance under its buy-back incentive are recovered from shippers via Transco's SO commodity charge. However, the costs of Transco's buy-back actions and revenue from incremental capacity sales made on the day are recovered via the capacity neutrality arrangements. Under these arrangements the net cost of buy-backs, after subtracting revenue from overrun charges, are recovered on the basis of individual shipper's MSEC capacity holdings across all Aggregate System Entry Points for that month.

At present, revenues from the sale of additional entry capacity on the day at individual terminals are apportioned to shippers on the basis of their individual MSEC holdings at the terminal at which the capacity is released.

The proposal

This modification proposal provides for a change to the basis on which capacity neutrality arrangements are recovered from shippers, from the current basis of MSEC holdings, to national end of day firm entry capacity holdings. The calculation of holdings would therefore reflect purchases of monthly and daily system entry capacity, as well as any other firm capacity products that may be introduced and would take into account shipper trades of firm capacity and firm capacity surrender to Transco.

Transco has proposed that, if implemented, this change would be implemented from 1 October 2002.

While not part of this proposal to amend the Network Code, Transco made a comment in its draft Modification Report that it would use reasonable endeavours to accept zero-priced buy-back offers made prior to 17:00 hours on a gas day thereby reducing shippers' end of day firm capacity holdings.

Respondents' views

Of the respondents commenting on this proposal, the majority expressed support for it, with some of these respondents qualifying their support.

Nature of the entry capacity products

One respondent expressed the view that on the day, firm capacity is a homogenous product and there is a no reason why MSEC and DSEC should not face the same liability.

Cost targeting

One respondent argued that the proposal would facilitate a more focused targeting of costs on the day. It stated that, currently, a shipper could offer its entire capacity holding to Transco to alleviate a constraint yet still incur a cost as part of the capacity neutrality smearing mechanism. This respondent felt that the current treatment was inappropriate and inefficient and may act as a deterrent to shippers wishing to trade capacity to other shippers or offer capacity back to Transco. It also argued that this might be inflating buy-back prices.

One respondent opposed the arrangements of targeting all shippers holding firm entry capacity for constraints caused at specific NTS entry points and believed that costs should be targeted at the entry points where they occur. Another respondent, while supporting this proposal, considered that further changes proposed in Modification Proposal 0490/0490a, 'Adjustment to ASEP Capacity Revenue Neutrality calculation', were desirable.

Link between MSEC purchases and buy-back liabilities

One respondent felt that it is appropriate to break the direct link between MSEC purchases and buy-back liabilities, which it considered should lead to a more efficient allocation of the primary product. It further felt that the change should improve investment signals, because shippers will not necessarily factor in the buy-back risk when developing their bidding strategies.

One respondent, while considering that these arrangements may be appropriate for MSEC, expressed a preference for a long-term product that has no attached liabilities, in order to make the product easier to value and to improve the investment signals to Transco.

Effect on liquidity of capacity markets

A number of respondents agreed that the proposal will increase liquidity in the capacity markets and specifically will encourage shippers to trade any surplus capacity and to offer capacity back to Transco. They argued that this should reduce buy-back costs. One respondent stated that this proposal should incentivise users to purchase capacity for their physical requirements.

By contrast, another respondent against the proposal considered that it would lead to shippers buying less capacity in the long-term auctions and holding off until the gas day to secure their capacity needs. It argued that this would lead to reduced investment signals for Transco and consequently higher buy-back costs.

This respondent also argued that this proposal would adversely affect those shippers that buy capacity for short-term needs, such as bringing gas onto the NTS from storage.

Transco's proposal to seek a change to its Operational Guidelines to accept zero-priced buy-back offers

Some respondents supported shippers being able to place zero-priced buy-back offers, with Transco using reasonable endeavours to accept such offers. However one opposed a 17:00 hours deadline, because it argued that this will enable Transco to avoid taking necessary buy-back actions in order to maximise its incentive revenues. It also argued that this is too early in the gas day for shippers to have an accurate position of their capacity requirements and may lead to an increase in overrun charges incurred. It believed that a more appropriate cut-off time would be close to the end of the gas day.

A number of other respondents also considered that Transco's proposed 17:00 hours deadline is too early in the gas day for shippers to have an accurate position of their capacity requirements.

One respondent wished to see a more automated process for Transco accepting zero-priced offers rather than a reasonable endeavours based approach. This respondent also indicated that it would not support implementation of Transco's proposal unless these concerns were addressed.

A number of respondents did not support Transco's proposal to buy back all zero-priced offers, because they argued that this would adversely affect competition in the capacity market.

Timing

A number of respondents expressed concerns with the timing of this modification proposal because of its proximity to the entry capacity auctions. One respondent argued that shippers need to be aware of this decision before the forthcoming MSEC auctions so that shippers are certain of the liabilities associated with the product they are purchasing.

Another respondent opposing the proposal considered that this proposal raised wider issues that needed to be more fully discussed within the industry. This respondent raised concerns regarding the timing of the proposal and indicated that the proposed change would have an impact on the way in which the capacity product is valued and therefore strongly opposed any changes to the arrangements that would affect the definition of a product that has already been auctioned (on the assumption that a decision would not be made on this proposal until after the auctions had occurred). One respondent indicated that there should be a period of stability in the period immediately preceding the auctions and that this proposal, by virtue of its timing, reduced that stability. The respondent therefore did not support the proposal.

One respondent was concerned with the proposed implementation date of October 2002, because, it argued that this would initiate change two months after the long-term entry capacity auctions in August and the impact of the change would not be fully understood.

Other issues

One respondent against the proposal argued that the it impacts directly on Transco's incentives because it increases the incentives on shippers to give their capacity back to Transco, rather than Transco paying the market price for capacity. It argued that changes made to the way costs and revenues from daily sales and buy-backs are apportioned before Transco's licence arrangements are understood makes it more difficult to understand these changes. This respondent also said that changes to the regime prior to the auctions should be kept to a minimum to assist shippers in valuing the capacity product.

Another respondent opposed the modification and stated that it is inappropriate to implement the proposal until the suggested changes to Transco's GT licence, and subsequent changes to Transco's supplementary statements have been made. This respondent stated that short-term reactive changes in the regime may reduce market liquidity.

Transco's view

Transco believes that an efficient regime should enable shippers to manage liabilities by trading on capacity and that a common liability regime should apply to all firm capacity. Transco argued that the proposal should provide a stimulus to secondary market trading. Transco argues that the proposal should enhance liquidity in capacity markets, which is consistent with promoting competition between shippers. It also argues that the proposal is expected to assist in the economic and efficient operation of its pipeline system as increased trading of capacity should provide Transco with appropriate signals as to the value of capacity. Transco states that increased liquidity could reduce buy-back prices and hence capacity management costs. Transco added that the proposal removes discontinuities between firm capacity products.

Transco stated that it will give consideration to the issues raised by respondents concerning its proposal to use reasonable endeavours to accept zero priced buy-back offers prior to 17:00 on the day. In particular it indicated that it would consider the issues associated with using different 'deadlines' for this procedure. Transco stated that the introduction of the procedure might require a change to its Operational Guidelines as a contingency in case the various supplementary statements required in Ofgem's proposed modifications to Transco's GT licence were not effective by 1 October 2002.

Ofgem's view

Ofgem has carefully considered this proposal and the responses made to it. Ofgem notes the concerns expressed by some respondents about the timing of this proposal, which has been made close to the commencement of the forthcoming MSEC auctions. Transco has however recently announced that it plans to commence the MSEC auctions from 16 August 2002, which should enable shippers to take the effects of this decision into account in formulating their bidding strategies.

Ofgem considers that the proposal better facilitates the securing of effective competition between shippers by ensuring that a consistent treatment for the recovery of buy-back costs is applied to firm entry capacity irrespective of the method by which the holder acquired the rights.

Ofgem also considers that the proposal may increase the liquidity of secondary capacity markets by encouraging shippers to trade capacity. Ofgem agrees that this would better facilitate the securing of competition between shippers and may assist in reducing buy-back costs with a positive impact on customers.

The proposal may also lead to a more focused targeting of buy-back costs on the day, by taking into account trades of capacity. This may be the case, for example, if a shipper reduces its flows onto the NTS and trades its capacity holdings at a particular constrained terminal to another shipper who intends to flow against the capacity. In this instance, the shipper purchasing the capacity rights would face a portion of any buy-back costs rather than the original capacity holder that has not flowed against the rights it had originally purchased.

Ofgem notes that Transco's proposal to use reasonable endeavours to accept zero-priced buy-back offers made before 17:00 hours does not form part of this modification proposal and may in fact form the subject of a future modification to the Operational Guidelines. As a result in approving this modification proposal Ofgem is making no comment on any future proposals by Transco to seek to amend its Operational Guidelines or any other statement that Transco may be required to produce under any future GT licence obligations it may have.

Ofgem's decision

For the reasons outlined above Ofgem has decided to direct Transco to implement this modification proposal because we consider that it better facilitates the achievement of the objectives of the efficient and economic operation by the licensee of its pipeline system and the securing of effective competition between relevant shippers and relevant suppliers, as outlined under Standard Condition 9 of Transco's GT licence.

If you have any queries in relation to the issues raised in this letter, please feel free to contact me on the above number or Lyn Camilleri on 020 7901 7431.

Yours sincerely,

Mark Feather
Head of New Gas Trading Arrangements